

# Not All Credit Enhancement Programs Created Equal

## Municipal Bond Strategy Report

### Strategy Highlights

- State credit enhancement programs are intended to provide additional security for bondholders of local school-district bonds. Given that investors understand the nuances of different programs, these local school-district bonds can provide an effective way to improve the quality and diversification of a municipal bond portfolio.
- The purpose of state credit enhancement programs is to provide a safety net, and the degree of value added is dependent upon the type of support, the credit quality of the state relative to the issuing district's credit quality, and the timing of the cash infusion by the state for debt service.
- Not all credit enhancement programs are created equal. We have identified four broad categories into which the major credit enhancement programs fall: **state-aid intercept/withholding, state appropriation, state guarantee, and state permanent funds.**

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State credit enhancement programs are designed and intended to boost the credit quality of bonds of a particular issuer, usually a public school district. Bonds backed by such programs offer a way to improve the quality and diversification of a municipal portfolio in which investors get local exposure with some backing from the state. While credit enhancement programs provide an additional layer of safety for bondholders, they can also benefit the issuer by lowering their borrowing costs, since the local district is able to borrow based on the credit strength of the program backing the bonds.

However, not all credit enhancement programs are created equal. While some program-backed bonds have credit ratings that are aligned with those of the respective states, others have ratings independent of the state and based on a permanent fund that secures the bonds or otherwise. Additionally, support for some bonds is limited to an annual appropriation amount by the state, while others have standing appropriations providing full support to the bonds.

While the characteristics of the various programs vary by state, we have identified four broad categories of types of backing:

### 1. State-Aid Intercept/Withholding Programs

The foundation of a state-aid intercept or withholding program is the state-aid payments that are periodically disbursed to school districts. When a state provides intercept support to the district's bonds, it essentially diverts the district's share of state aid to the bond-paying agent in the event the issuer cannot make its full and timely debt-service payment. While the basic mechanism is similar for all intercept programs, there are differences in the level of support provided by the state.

Among intercept bonds, the highest-rated ones usually have full and timely debt-service support from the state regardless of the amount of unpaid state aid remaining at the time of the intercept. In this case, the state stands behind the bonds no matter how much is needed to cover debt service for the bonds.

Equally strong in many cases would be bonds that have limitations on support to the amount of unpaid aid. These states typically maintain an amount in remaining state aid that is some multiple of maximum annual debt service (MADS); usually two times the MADS. Such a practice reduces the likelihood that the state aid will be insufficient to fully cover debt service.

There are, however, intercept programs that do not provide full and timely payment support or any coverage requirements. These programs are generally rated lower by rating agencies due to the weaker and uncertain security.

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## 2. Appropriation Programs

State appropriation programs involve the state's ability to allocate, or appropriate, funds to provide debt service for a participating local government. The two types of appropriations are standing appropriation and annual appropriation. Standing appropriations are usually rated at the same level as the state and are not subject to appropriation risk. The other type are annual appropriation programs, which are subject to appropriation risk each fiscal year and are therefore usually rated a notch below the state's rating.

## 3. State Guarantee Programs

State guarantee programs, as the name suggests, provide guarantees for school bonds, typically for general obligation bonds. In the event that a school district is unable to pay debt service on its bonds, the state has guaranteed the bonds. It is required to use its general fund or other available funds to pay debt service on the district's behalf. Bonds guaranteed under these programs are generally rated in line with the state guaranteeing the bonds.

## 4. State Permanent Fund Programs

State permanent funds are typically constitutionally created, and the funds' balance, or corpus, are used as security for the bonds. An important fact to note about state-permanent-fund-backed bonds is that their credit quality and ratings are independent of the state's. Normally, there would be a constitutionally created leverage limit, which is the total bonds backed by the program as a multiple of the corpus. Additionally, there are rules intended to protect the corpus.

## Not All Programs Are Created Equal

An important consideration for bondholders should be the differences among the various credit enhancement programs, even within the same category. Additionally, there are some instances in which the district itself is rated higher than the state that backs it. This would usually be true for more affluent cities with better funded school districts. In this case the enhancement provides less benefit. Another important consideration in both intercept and appropriation programs is whether the support from the state is provided before or after default on debt service from the district. In our view bonds with pre-default assistance from the state are stronger than the alternative. Intercept programs without a full support guarantee or with no coverage requirement of state aid, or those programs with higher risk

related to their annual appropriations from the state, in our opinion, provide the weakest enhancement among the various categories. When investing in bonds backed by such programs, it is still important to consider the credit quality of the underlying school district

## Conclusion

While the purpose of state credit enhancement programs is to provide a safety net, the degree of value added is dependent upon the type of support, the credit quality of the state relative to that of the issuing district, and the timing of the cash provided state for debt service. Given that investors understand and take into consideration the nuances of the various programs, state credit enhancement programs are an effective way to improve the quality and diversification of a municipal portfolio.

*Listed below are some of the states that have credit enhancement programs and the categories the programs fit the most. Please note that the list is not comprehensive. To check if a bond has credit enhancement provided by the state or to find out updated ratings on enhanced bonds, ask your financial advisor, as ratings may differ within the same program or state.*

State Program	Program Category
Arkansas School District Intercept	State-Aid Intercept
Colorado School District Credit Enhancement	State-Aid Intercept
Georgia School District Intercept	State-Aid Intercept
Idaho School Bond Guaranty	State Guarantee
Indiana School District State Intercept	State-Aid Intercept
Kentucky School District Enhancement	State-Aid Intercept
Massachusetts Qualified Bond	State-Aid Intercept
Michigan School Bond Qualification & Loan Fund	State Guarantee
Minnesota School Dist Credit Enhancement	State Appropriation
Missouri School District Direct Deposit	State-Aid Intercept
Nevada Permanent School Fund	State Permanent Fund
New Jersey School Qualified Bond	State-Aid Intercept
New Jersey School Bond Reserve Act	State Guarantee
New Mexico School District Enhancement	State-Aid Intercept
New York State Aid Intercept	State-Aid Intercept
Ohio School Dist Credit Enhancement	State-Aid Intercept
Oregon School Bond Guaranty	State Guarantee
Pennsylvania School Dist Intercept	State-Aid Intercept
South Carolina School Dist Credit Enhancement	State Appropriation
Texas Permanent School Fund	State Permanent Fund
Utah School Bond Guaranty	State Guarantee
Virginia Localities Intercept	State-Aid Intercept
Washington State School Bond Guarantee	State Guarantee
West Virginia Municipal Bond Commission	State Appropriation
Wyoming School District Bond Guarantee	State Permanent Fund

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You must evaluate whether a bond ladder and the securities held within it are consistent with your investment objectives, risk tolerance and financial circumstances. Including callable bonds may increase the interest rate risk of a bond ladder. Bonds may be called prior to maturity, which could result in lower yields with new investments.

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